

## A tax reform proposal

To the President's Economic Recovery Advisory Board:

thank you for taking proposals from the general public. Let me cut the chase.

### Executive Summary

My proposal is two-fold:

- 1) eliminate all taxes on human enterprise such as income, corporate and sales tax
- 2) collect the required level of revenue from the market value of natural resources -*at the source*-. Most importantly collect the economic rent of Land

Bear with me as I attempt to argue the case in terms that the general public can understand and that can be used to mount public support.

### Elimination of taxes on human enterprise

Income tax, corporate tax, sales tax and other forms of taxation on human enterprise are effectively a brake on the economy, in the form of a clamp on opportunities. A few typical scenarios portraying the problem:

- **An expanding employer** wishes to hire a worker because it fits perfectly the required profile. However, while the worker is happy with a take-home pay of 4,000 dollars (after tax) a month the employer sees an expense of anywhere between 6,000 and 8,000 dollars a month, due to taxes and other mandatory contributions. The employer therefore decides it cannot afford this worker and must either take a cheaper and in general less suitable worker or give up its prospects for expansion. Lose/Lose/Lose situation: the worker doesn't get hired, the company doesn't expand, the government loses revenue it would have earned from the expansion.
- **A potential employee** considers an offer for an open position at an expanding firm for which is particularly well suited. The offer involves a (pre-tax) salary of 5,000 dollars a month as that's what the firm can afford. The potential employee would be perfectly happy with that figure but what she really must consider is the, take-home figure which is an (after-tax) 3,000 dollars a month, too low for her. She therefore decides not to take the job. Lose/Lose/Lose situation: the potential employee doesn't take a job she would be well suited for, the firm cannot provide the level of service it wishes to provide and the government loses revenue it would have earned from the firm's improved profits due to the improved service.
- **A customer in a shop** is considering the purchase of a shirt he really likes. Unbeknownst to him the manufacturing, transportation and handling cost of the shirt from production to retail is 15 dollars. Taxes along the whole supply chain however have inflated the price to 30 dollars. He only has 24 dollars in his pocket. He decides not to make the purchase or settles for a cheaper shirt. Lose/Lose/Lose situation: the customer doesn't get what he wants, the seller doesn't earn as much as he could have, government loses revenue.

All these scenarios have one aspect in common: taxes have prevented a transaction from ever occurring, effectively slowing down the economy from what is its full potential.

A second, negative aspect of these forms of taxation is that they are relatively easy to evade. They rely on individuals and companies to honestly declare their income and while most do this requires a fairly complex system of checking and cross-checking. On another side of the barricade and given the barrage of existing subsidies, exemptions and outright loopholes, accountants help firms, especially those who can pay the most, to “legally” avoid taxes.

This has four large consequences:

- 1) government must spend vast amount of money to keep evasion in check, raising the cost of government and therefore taxes
- 2) firms who can afford it must spend vast amount of money in accounting costs to minimize the impact of taxes on profits
- 3) the poorest who cannot afford it end up painfully parting from a large proportion of their income because of direct and indirect taxes, reducing their disposable income to level below the poverty line and helping crime and the black market as a consequence
- 4) the richest end up paying the bulk in absolute terms, but as it is a small proportion of their large income they end up hoarding wealth and capital that would otherwise remain in circulation, further slowing the economy

This is often considered the “natural”, inevitable status-quo, a necessary evil. I beg to differ.

### **Collection of the economic rent of a site**

Any economic system, especially on a finite planet with a large and growing population, must ensure that resources are used efficiently. At the same time it must allow for the population to seize the opportunities to express their creativity, ingenuity and enterprise, to ultimately foster genuine, positive progress for all.

Albeit nature kindly provides us with many resources it can be argued that the most important of all is Land. Nearly all human activity is dependent on Land and the human species cannot survive without it.

From an economic perspective however Land is quite different from other commodities. The value of any given site doesn't go up and down like normal items such as a new car or the services of a carpenter. The market price for normal goods and services usually depends on both the quality and quantity offered by the producers and the quantity and quality demanded by the consumers. On the whole however, Land is available in a largely fixed quantity. This causes the market value of Land to only respond to how much buyers are willing to pay. And this in turn is directly dependent on the financial prosperity at the local, national and global economies.

For example, when property prices raise, it isn't the roofs, the walls or the windows of the buildings that increase in value. Those in fact *depreciate* due to the wear and tear that

comes with normal use, no differently than the diminishing value of a used car or a used sweater. What increases in value is the market value of the *location* on which the property sits, also known as its economic rent. And that's something that the owner of the property is not responsible for and should therefore receive no reward nor penalty for. For example, in London, UK, taxpayers financed the extension of a subway line at the cost of 3 billion pounds. It was eventually calculated that this improvement in the public infrastructure raised the property prices near the new subway stations virtually overnight, to the tune of 40 billion pounds, all effectively pocketed by the landlords in the area. The landlords hadn't done anything to improve their buildings to warrant such increase in value. But the location on which their buildings sat did increase in value, thanks to the taxpayers.

The opposite can happen too. A property owner might have just improved his property, i.e. getting back into shape a ruined building, constructing an extension or even just redecorating its interiors. However as a local, national or global recession hits he might be forced to sell the house quickly, at a loss, because he must relocate to a different city for work. He didn't do anything to deserve the loss, quite the opposite: he improved the property, and indirectly the neighbourhood, the nation and ultimately the planet! At -least- he should recover his costs and ideally he should even make some profit for his vision and efforts! But no, something on which he has largely no control nor responsibilities, the recession, has lowered the value of the site and has hastened the sale causing a loss.

Who is responsible then, for the value of a location and who should reap the rewards or suffer the consequences of any increase in that value? It is the local, national and global communities that with their economic activities give value to a particular site. It is therefore the local, national and (one day!) the global communities that should obtain their funding primarily, if not uniquely, through the collection of the economic rent of a site (\*) from its owner. In this context, an important ingredient of this reform is to tie a close loop between revenue from a site and the services and improvements available to that site. This will ensure that the benefits of higher economic activity in area are clearly felt by its people, inducing efforts for further improvements and creating a positive feedback loop.

(\*) the economic rent of a site can be calculated as the market value of the site minus any existing improvements the site enjoys that are accountable to the owner.

### **Extending the scheme to other natural resources**

Land is the most important of all natural resources but government at all levels can extend the concept described in the previous section to other resources, especially vital or scarce ones where efficiency is paramount. The UK government benefits from revenue from the oil fields in the Northern Sea. However, at least part of the revenue does not derive from an arbitrary level of corporate taxation levied against those owning the extractions right. It is dependent on how easy it is to reach and extract the oil. Fields requiring the least effort and therefore more profitable are taxed the most. Fields requiring the most effort have instead the least level of taxation or no taxation at all. This allow for the mining companies active on those fields to still make a profit, for more oil to reach the market and for the consumers to enjoy lower prices at the pump. Newly available radio frequencies in the electromagnetic spectrum are being leased for a finite number of years by the UK government, to the highest bidder. Although this is a completely different resource and the collection method is very different the concept is still the same: the market value of a resource is recurrently captured by society rather than a private owner as it is society as a whole that gives value to a particular frequency range. Given these two wildly different examples no doubts the same concept can be applied to resources such as water, or the

capacity of the atmosphere to absorb carbon and other pollutants.

## **Benefits**

Taxing resources, especially Land, rather than individuals', corporations' or other institutions' efforts has three important advantages:

1. it releases the hand brake from an economy. Prospective employers and potential employees will be looking at the same tax-free numbers, reducing unemployment while increasing overall productivity and efficiency. Meanwhile buyers and sellers will deal with prices that are only the result of the production chain and are dependent on the market value of the used resources rather than prices inflated by the taxation on every step of the chain.
2. it rewards efficient use of resources, steering the economy away from resource overuse, abuse and from intense, risky price-raising resource speculation. While some speculation might still be helpful to lead the markets to an appropriate value, capturing -most- of the economic rent of a resource will dramatically reduce any speculation on it. For example, why speculate intensively on a piece of land if any future increase in its market value is captured back by society? As a prospective owner, the only thing I'd be left with is to pull up my sleeves and improve the way -I use- that land, which is exactly what an economy should encourage.
3. it is a fundamentally simpler form of taxation, greatly reducing the potential for evasion and therefore the need for high government spending to keep evasion in check. For example, Land, intended as a geographical location, cannot be hidden. Therefore as long as somebody requires an exclusive use for it a revenue can be collected.
4. it eliminates the current injustices while providing fair incentives across the whole spectrum: the poorest and the richest members of society alike would be able to completely collect the rewards of applying their skills and efforts to their business.

## **Transition:**

The transition doesn't have to be overnight and can be ramped up as the benefits become obvious and the public support mounts. For example, in the context of Land an end goal could be the collection of 4% of the market value of a site every year, so that every 25 years the government effectively has collected the site's full value. But as a starter the government could collect only a small proportion of that final level, to be ramped up over 10-15 years to avoid the unease due to sudden change. Obviously this proposal also advocate for all other taxes to be ramped down over the same period.

## **Conclusion:**

I highly recommends this reform: switching from taxing efforts to taxing natural resources according to their market value, with particular emphasis on collecting the market value of Land, intended as the economic rent of a geographical location.

I am available for further discussion. Feel free to contact me at [manu3d@gmail.com](mailto:manu3d@gmail.com).

Sincerely, Emanuele D'Arrigo, October 14<sup>th</sup>, 2009